

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ackerman Analyst: Colin Stevens Bill Number: AB 190

Related Bills: AB 1694 (1998) Telephone: 845-3036 Introduced Date: 1/21/99

Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: Revised Due Date for the Limited Liability Company Annual Tax

SUMMARY

Under the Revenue and Taxation Code, this bill, sponsored by the Franchise Tax Board, would make the annual tax of an limited liability company (LLC) classified as a partnership or whose entity status is disregarded due and payable on the due date of the LLC return.

EFFECTIVE DATE

As a measure that would affect the timing, but not the amount of tax payments, this bill would be operative January 1, 2000, and would apply to all payments due after January 1, 2000.

BACKGROUND

The Business Entities Section of the department's Processing Services Bureau conducted a study of 500 randomly selected LLC returns (CA Form 568) for tax years 1995 and 1996. The study found that 73% of the returns contained errors related to the payment of tax: either no annual tax was paid, or the tax was paid with the return rather than with the required form FTB 3522 on or before the 15th day of the fourth month of the taxable year. The error rate appears to be declining as educational programs are implemented; however, the error rate is still high, as is the growth in LLC formations (approximately 1,500 - 2,000 per month). The LLC Interim Billing Project is billing late paying LLCs for current year annual tax, annual fee, interest, and penalties. The first bills were sent in late August 1998. Bills continue to be sent out. As of January 22, 1999, approximately 8,800 of the nearly 15,000 billing notices had been sent out with balances totaling approximately \$416,500.

SPECIFIC FINDINGS

Under federal law, a business entity (other than a "corporation per se") is an "eligible entity" and may elect its classification for tax purposes. An LLC is an eligible business entity and may be treated and taxed under federal law as a corporation, a partnership, or entirely disregarded as a separate entity. Fewer than 25 of approximately 40,000 LLCs in California are classified as corporations.

Board Position:

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<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Gerald Goldberg

2/25/1999

California law adopted federal law concerning the classification of business entities for tax purposes, with some minor modifications. In particular, the tax and fee previously imposed on an LLC classified as a partnership now apply to any LLC not classified as a corporation, including an LLC that is otherwise disregarded for federal and state tax purposes. In general, the classification of a business entity in California must be the same as its federal classification.

Existing state law imposes on a corporation doing business in this state a tax to be paid annually for the privilege of exercising its corporate franchise within this state. The tax is the greater of the minimum franchise tax, currently \$800 (certain qualifying new corporations pay a reduced amount), or the tax according to or measured by its net income computed at the current rate of 8.84%. For the first year, the minimum franchise tax is paid to the Secretary of State (SOS) with the filing of the articles of incorporation. For a corporation deriving income from California sources (but not doing business in this state), the tax rate also is 8.84%, but the corporation is not required to pay the minimum franchise tax.

Existing state law requires individuals and corporations to have taxes withheld or make estimated tax payments throughout the taxable or income year. In the case of corporations, the first estimated tax payment, due by the 15th day of the fourth month after the beginning of the income year, must be an amount at least equal to the minimum franchise tax (\$800).

Under current state law, a foreign or domestic LLC classified as a partnership or disregarded for tax purposes that is doing business in this state is required to annually pay a tax and a fee. The annual tax is for the privilege of doing business in this state; the amount is equal to the minimum franchise tax. The annual fee is determined by the amount of total income of the LLC from all sources reportable to this state.

Existing state law requires the tax on LLCs to be paid on or before the 15th day of the fourth month of the taxable year. The FTB provides the LLC tax voucher form FTB 3522 for this remittance.

Existing state law requires the fee of an LLC to be paid on the date the return for the LLC is required to be filed. The return for an LLC classified as a partnership is due on or before the 15th day of the fourth month after the close of the taxable year. The return for an LLC that is disregarded is due on or before the 15th day of the fourth month after the close of the taxable or income year of the owner of the disregarded LLC.

Existing state law requires limited partnerships (LPs) and limited liability partnerships (LLPs) formed, registered, or doing business in this state, to annually pay a tax for the privilege of doing business in this state. The amount of this annual tax is equal to the minimum franchise tax. This tax is due and payable on the date the return of the LP or LLP is required to be filed, the 15th day of the fourth month after the end of the taxable year. However, unlike LLCs, LPs and LLPs are not otherwise taxable or subject to additional fees.

This bill would make the annual tax of an LLC classified as a partnership or whose entity status is disregarded due and payable on the due date of the LLC return, rather than on the 15th day of the fourth month of the LLC's taxable year.

Policy Considerations

By making the payment of LLC tax similar to taxes paid by LPs and LLPs, this bill would result in greater simplicity for both the department and taxpayers by making more uniform the calculation, payment, and administration of taxes.

Implementation Considerations

This bill will improve the department's operations by eliminating an area of taxpayer error and confusion.

If this bill is adopted, some taxpayer education and changes to tax booklets and instructions would be required so taxpayers and tax preparers will be aware of the change in the due date of the LLC minimum tax. These changes can be handled during the department's normal annual updates.

FISCAL IMPACT

Departmental Costs

By reducing taxpayer errors, this bill may result in a minor but undeterminable savings of departmental costs.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses as shown below.

Estimated Revenue Impact of AB 190 (In \$Millions) Enactment Assumed After 4/15/99			
Fiscal Years	1999/00	2000/01	2001/02
Revenue Impact	(15)	(1)	(1)

This revenue estimate does not take into account any possible changes in employment, personal income, or gross state product that might result from this measure.

Tax Revenue Discussion

This bill is essentially a timing issue and would not affect the total amount of state income tax revenue received over the long run, but would result in the one-year deferral of \$15 million. However, the year in which the deferral occurs would depend upon the enactment date of this bill.

Assuming enactment in 1999, this bill would result in the delayed receipt of revenue as shown below. This bill would defer the receipt of \$15 million in revenues from the 1999/2000 fiscal year to 2000/2001, resulting in a \$15 million deferral for 1999/2000. Additional deferrals of \$1 million are assumed due to growth of new LLCs that would otherwise pay taxes in an earlier fiscal year. A growth rate of 5% was used to calculate the growth of LLC formation.

BOARD POSITION

Support. At its December 15, 1998, meeting, the Franchise Tax Board voted to sponsor this bill.